



Memorandum

Date

JUN 1 1992

From

Richard P. Kusserow
Inspector General

Subject

Audit of Medicare Contractor's Segmented Pension Cost, Blue
Cross and Blue Shield of Michigan, Inc. (A-07-91-00471)

To

William Toby
Acting Administrator
Health Care Financing Administration

This is to alert you to the issuance on June 2, 1992, of our final audit report. A copy is attached. The audit examined Blue Cross and Blue Shield of Michigan, Inc.'s (Michigan) implementation of its Medicare contract clause on pension plan segmentation. The clause required Michigan to identify, allocate, and report pension assets and costs separately for Medicare segments. Compliance required Michigan to: (1) compute actuarial liabilities for the Medicare segments as of 1981, (2) determine a ratio of Medicare's total actuarial liability to the plan's total actuarial liability as of 1981, (3) allocate a portion of the total pension assets as of 1986 to Medicare based on the 1981 ratio (computed in item 2), (4) update the 1986 Medicare assets to 1990, and (5) assess whether Medicare's pension costs should be determined by a separate segmented calculation.

Michigan omitted 98 participants in computing the actuarial liability of the Medicare segment for 1981. Michigan's omission of Medicare segment participants understated the 1981 asset fraction. When applied to the 1986 pension assets, Michigan's fraction understated Medicare's pension assets as of 1986 by \$581,632. We are recommending that pension assets of the Medicare segment be increased by \$581,632 as of 1986 and that the increase be carried forward as an increase to the pension assets as of 1990.

Medicare's pension assets were understated by another \$4,440,241 in the updating of the Medicare segment assets from 1986 through 1990. The understatement occurred because Michigan: (1) recognized only parts of the annual asset gains and losses and (2) did not adjust for distortions caused by participant transfers in and out of the Medicare segment. We

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are recommending that Michigan increase the Medicare segment pension assets by an additional \$4,440,241 as of January 1, 1990.

Michigan agreed with recommendations contained in the draft report. The Health Care Financing Administration (HCFA) did not provide us with written comments relative to the draft report. However, HCFA verbally agreed with our recommendations.

Attachment

For further information contact:
Vincent R. Imbriani
Regional Inspector General for
Audit Services, Region VII
816-426-3591

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF MEDICARE CONTRACTOR'S
SEGMENTED PENSION COST,
BLUE CROSS AND BLUE SHIELD OF
MICHIGAN, INC.**



**Richard P. Kusserow
INSPECTOR GENERAL**

A-07-91-00471



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Office of Audit Services

Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

CIN: A-07-91-00471

JUN - 2 1992

Ms. Catherine Schmitt
Director, Budget Reporting and Planning
Blue Cross and Blue Shield of Michigan
600 Lafayette East
Detroit, Michigan 48226

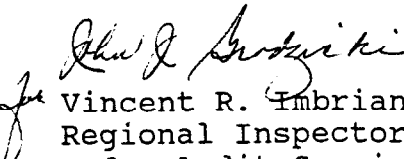
Dear Ms. Schmitt:

Enclosed for your information are two copies of an Office of Inspector General (OIG), Office of Audit Services (OAS) report titled "Audit of Medicare Contractor's Segmented Pension Cost, Blue Cross and Blue Shield of Michigan." Your attention is invited to the findings and recommendations contained in the report. The below named official will be communicating with you in the near future regarding implementation of necessary actions.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG, OAS reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5.)

To facilitate identification, please refer to the above audit control number in all correspondence relating to this report.

Sincerely,


for Vincent R. Imbriani
Regional Inspector General
for Audit Services, Region VII

Enclosure

Action Official:
Chester C. Stroyny
Regional Administrator, Region V
Health Care Financing Administration
105 West Adams Street, 15th Floor
Chicago, Illinois 60606

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FOR THE PERIOD JULY 1, 1986 TO JANUARY 1, 1990

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FOR THE PERIOD JULY 1, 1986 TO JANUARY 1, 1990

APPENDIX C- AUDITEE COMMENTS

SUMMARY

Beginning with Fiscal Year (FY) 1988, Blue Cross and Blue Shield of Michigan (Michigan) was required to comply with a new contract clause on pension cost segmentation. The clause required Michigan to identify, allocate, and report pension assets and costs separately for the Medicare segment. Compliance required Michigan to: (1) compute actuarial liabilities for the Medicare segment as of 1981, (2) determine a ratio of Medicare's total actuarial liability to the plan's total actuarial liability as of 1981, (3) allocate a portion of the total pension assets as of 1986 to Medicare based on the 1981 ratio (computed in item 2), (4) update 1986 Medicare assets to subsequent years, and (5) assess whether Medicare's pension costs should be determined by a separate segmented calculation. Medicare pension costs, whether allocated or separately calculated, were to be computed, assigned, and adjusted in accordance with the Cost Accounting Standards (CAS).

Michigan omitted 98 participants in computing the actuarial liability of the Medicare segment for 1981. Michigan's omission of Medicare segment participants understated the 1981 asset fraction. When applied to the 1986 pension assets, Michigan's fraction understated Medicare's pension assets as of 1986 by \$581,632. We are recommending that pension assets of the Medicare segment be increased by \$581,632.

Medicare's pension assets were understated by another \$4,440,241 in the updating of the Medicare segment assets from 1986 through 1990. The understatement occurred because Michigan: (1) recognized only parts of the annual asset gains and losses and (2) did not adjust for distortions caused by participant transfers in and out of the Medicare segment. We are recommending that Michigan increase the Medicare segment pension assets by an additional \$4,440,241 as of January 1, 1990.

Michigan agreed with the recommendations contained in this report.

INTRODUCTION

BACKGROUND

Title XVIII of the Social Security Act, Health Insurance for the Aged and Disabled (Medicare), provides that organizations may assist in administering the Medicare program under contracts with the Secretary, U.S. Department of Health and Human Services. Most Medicare contractors, intermediaries (Part A) and carriers (Part B), performed under cost reimbursement contracts that were renewed annually. Michigan has administered Medicare Parts A and B operations under cost reimbursement contracts since 1966.

Contractors were to follow cost reimbursement principles contained in their contracts, the Federal Acquisition Regulations (FAR), which superseded the Federal Procurement Regulations (FPR), and the CAS. A fundamental reimbursement principle in the contracts is that the contractor "...shall be paid its costs of administration under the principle of neither profit nor loss..."

To ensure that a no profit, no loss principle was followed concerning pension costs, we issued an audit report to the Health Care Financing Administration (HCFA) in 1985. The report was titled "Medicare Intermediaries and Carriers Should Be Required To Use Segment Accounting For Claiming Pension Costs" (ACN: 07-52013). The report showed that pension contributions charged to Medicare exceeded the requirement to meet Medicare's pension liabilities. The report recommended that HCFA amend Medicare contracts to require treatment of Medicare as a separate segment for calculating and charging pension costs.

The HCFA incorporated segmenting requirements into Medicare contracts starting with Fiscal Year 1988 and distributed a pension cost questionnaire to contractors in 1989. The questionnaire was to ensure that contractors had, and would maintain, data necessary to make and document the segmentation calculations.

Michigan submitted its questionnaire response on June 8, 1989. The response identified the Medicare segment as the Government Business Division (GBD) and a part of the Provider Audit Section (PAS). The response identified, as of July 1, 1986, total pension assets of \$153.1 million and Medicare segment assets of \$13.5 million. Michigan also concluded that separate valuations were required for the Medicare segment.

Until July 1, 1985, Michigan employees were covered by one defined benefit pension plan. Subsequently, employees could belong to one of two pension plans. They were the original (Regular) plan or a spin-off (Union) plan covering union employees.

CRITERIA GOVERNING SEGMENTED PENSION COSTS

Since its inception, Medicare has reimbursed a portion of annual contributions paid into contractors' pension plans. The Medicare reimbursements represented allowable pension costs in accordance with the FPR and/or the FAR. In 1980, CAS 412 and 413 were incorporated into both the FPR and the Medicare contracts:

"The cost of all defined benefit pension plans shall be measured, allocated, and accounted for in compliance with the provisions of CAS 412, Composition and Measurement of Pension Costs, and CAS 413, Adjustment and Allocation of Pension Costs."(FAR, section 31.205-6(j)(2))

The CAS 412 provided guidance for determining and measuring the components of pension costs. It also specified how pension costs were to be assigned to appropriate accounting periods. The CAS 413 provided guidance for valuing pension assets, allocating pension costs to segments of an organization, adjusting pension costs by measuring actuarial gains and losses, and assigning such gains and losses to cost accounting periods.

Pension costs were to be calculated separately for a segment whenever (i) there was a material termination gain or loss attributable to one operation of a company, (ii) benefit levels, eligibility or age distributions for the segment were materially different, or (iii) appropriate assumptions, such as termination rates or retirement ages, were significantly different for one organizational operation of a company (CAS, section 413.50(c)(2)).

Separate calculations were also required whenever pension plans of different segments were merged and the ratio of assets to actuarial liabilities was materially different after the merger(CAS, section 413.50 (C)(3)). Pension costs could be separately calculated for the segment for all participants or just active participants (CAS, section 413.50(c)(9)).

Another provision specified how to initially allocate the assets of a pension fund among segments (CAS, section 413.50 (c)(5)) and described how segment assets were to be adjusted each year (CAS, section 413.50 (c)(7)). Adjustments were required for transfers in and out of the segment if the ratios of assets to liabilities would otherwise be distorted (CAS, section 413.50 (c)(8)).

In addition to the CAS requirements, HCFA, starting with FY 1988, incorporated specific segmenting language into Medicare contracts. The contracts stated:

"The term 'Medicare Segment' shall mean any organizational component of the contractor, such as a division, department, or other similar subdivision, having a significant degree of responsibility and accountability for the Medicare contract/agreement, in which:

1. The majority of the salary dollars is allocated to the Medicare agreement contract; or
2. Less than a majority of the salary dollars is allocated to the Medicare agreement/contract, and these salary dollars represent 40 percent or more of the total salary dollars allocated to the Medicare agreement/contract."

The contracts also provided that pension assets of a Medicare segment be separately identified regardless of whether pension costs were allocated or separately calculated.

To implement the segmentation requirements, contracts stipulated procedures for allocating assets to identified Medicare segments. Assets were to be allocated as of the first pension plan year following the date the salary criteria was met, but not earlier than the first plan year starting after December 31, 1985. The asset allocation was to be based on the ratio of the actuarial liabilities of the Medicare segment to the total plan as of the first day of the first plan year starting after December 31, 1980. Contracts also identified when Medicare operations should have pension cost calculated separately for a segment.

In summary, Michigan's contract required: (1) computing the Medicare segment's actuarial liability as of 1981, (2) determining a ratio of Medicare's actuarial liability to the total actuarial liability as of 1981, (3) allocating a portion of total pension assets as of 1986 based on the 1981 ratio, (4) updating the 1986 Medicare assets to 1990, and (5) assessing whether Medicare's pension costs should be determined by a separate segmented calculation.

SCOPE OF AUDIT

Our examination was made in accordance with Government Auditing Standards. The audit only addressed pension segmentation requirements. The primary purpose was to determine Michigan's compliance with contract requirements involving pension segmentation. Accomplishing our objective did not require a review of Michigan's internal control structure.

Our review covered the period July 1, 1981 to January 1, 1990. We reviewed Michigan's identification of the Medicare segment as of July 1, 1988 and traced the organizational lineage of the segment back to 1981. Pension plan participants were determined by cost center for 1981 and for 1986 through 1990 using employee listings of Michigan's Personnel Department. The accuracy of the participant listings was verified to reports of full-time equivalent employees of Michigan's Government Program Department. Actuarial liabilities computed by Wyatt Company, Michigan's consulting actuary, were reviewed by HCFA's pension actuarial staff.

We reviewed Michigan's computation of the asset fraction for 1981. Also, we reviewed the update of Medicare assets from 1986 through 1990. The Wyatt Company provided us information concerning contributions, disbursements, and earnings.

In our review, we also used pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Forms 5500.

Site work at Michigan's corporate offices in Detroit, Michigan was performed during July, August, and September of 1991.

FINDINGS AND RECOMMENDATIONS

CONTRACTOR'S 1981 RATIO OF MEDICARE'S ACTUARIAL LIABILITY TO TOTAL PLAN'S ACTUARIAL LIABILITY

Michigan understated Medicare's 1986 pension asset allocation by \$581,632. Michigan calculated a 1981 asset fraction of 8.80 percent for the Medicare segment and applied it to 1986 total pension assets of \$153,055,900. In computing the asset fraction, Michigan inadvertently omitted 98 plan participants from the Medicare segment of the asset fraction. This resulted in an understatement of the asset fraction that, when applied to total pension assets, understated Medicare segment assets as of 1986 by the \$581,632.

The contract provided that Medicare segment assets were to be determined by:

1. Determining an asset fraction as of 1981. The numerator was to be the 1981 actuarial liability of the Medicare segment. The denominator was to be the 1981 actuarial liability of the total pension plan.
2. Allocating pension assets to the Medicare segment by applying the 1981 asset fraction to the actuarial value of the undivided pension fund assets as of the allocation date. Michigan's allocation date was July 1, 1986.

Medicare Participants Omitted From Segment

Using the contract definition of a segment, Michigan correctly identified the Medicare segment as consisting of its GBD and a part of its PAS. Michigan's current data base, which began in 1985, was used to identify active participants that were in the Medicare segment as of 1981. A 1981 asset fraction of 8.80 percent was calculated and applied to 1986 total pension assets of \$153,055,900. The result showed Medicare segment assets as of 1986 of \$13,468,900 (8.80 percent of \$153,055,900 rounded to the nearest \$100).

During our onsite review, Michigan became aware that its current data base did not include employees terminated before 1985. Using its current data base and a prior data base, Michigan reconstructed for us an accurate listing of Medicare segment participants for 1981. The information showed that Michigan had excluded 78 active participants of the Medicare segment in determining the numerator (actuarial liability of the Medicare segment) of the 1981 asset fraction. A review of additional information showed that 20 inactive participants were also excluded.

Michigan excluded 98 participants of the Medicare segment from the numerator of the asset fraction

Computation of Medicare Assets as of 1986

We calculated a revised 1981 asset fraction that included the 78 active and 20 inactive participants in the Medicare segment. The inactive participants were included because Michigan had included inactive participants in the denominator of the asset fraction. Our calculation showed a 1981 asset fraction of 9.18 percent and is summarized in the following table.

1981 Asset Fraction			
Category	Total Actuarial Liability (A)	Medicare Actuarial Liability (B)	Asset Fraction (B)/(A)
Actives	\$70,441,937	\$6,929,397	
Retirees	7,355,984	303,881	
Deferred Vested	1,322,946	36,085	
Other	<u>64,300</u>	<u>0</u>	
Total	\$79,185,167	\$7,269,363	<u>9.18 %</u>

We applied the revised 1981 asset fraction to Michigan's total pension plan assets as of July 1, 1986 to determine the Medicare segment's share of pension assets for both the Regular and Union plans. The revised asset fraction increased the Medicare segment assets by \$581,632 to \$14,050,532. Our calculations and Michigan's calculations are shown on the table on the following page. (Our calculations are not rounded while Michigan's are rounded to the nearest \$100.)

1986 Medicare Segment Assets			
Description	Asset Fraction	Plan Assets	Medicare Assets
	(A)	(B)	(B)X(A)
<u>OIG</u>			
REGULAR PLAN	9.18%	\$126,226,600	\$11,587,602
UNION PLAN	9.18%	26,829,300	2,462,930
Total			\$14,050,532
<u>MICHIGAN</u>			
REGULAR PLAN	8.80%	\$126,226,600	\$11,107,900
UNION PLAN	8.80%	26,829,300	2,361,000
Total			<u>\$13,468,900</u>
Difference			\$ 581,632

Recommendations

We recommend that Michigan:

1. Increase the 1986 pension assets of the Medicare segment by \$581,632 to \$14,050,532.
2. Increase pension assets of the Medicare segment as of January 1, 1990 by \$581,632 to reflect the 1986 adjustment.

Auditee Comments

"...we agree with the audit finding recommendation to increase the Medicare segment pension assets by \$581,632 to \$14,050,532 and to carry that increase forward to the January 1, 1990 segment valuation."

MEDICARE'S ASSET BASE AS OF 1986 UPDATED TO 1990

In accordance with contractual requirements, Michigan updated Medicare's asset base from July 1, 1986 to January 1, 1990. As a result of the methodology of the update, Medicare's asset understatement of \$581,632 increased by \$4,440,241 to \$5,021,873. The understatement occurred because Michigan used insufficient asset appreciation rates and did not consider transfers in and out of the Medicare segment.

Investment Gains And Losses

Michigan recognized expected interest rates of 7.5 percent for years 1986 through 1988 and 8 percent for 1989 in determining asset appreciation for the pension assets of the Medicare segment. Michigan recognized gains and losses for the total company pension plans using the same expected interest rates plus an adjustment for the difference between expected and actual earnings of the assets. Michigan's actuary agreed with us that this was inconsistent and acknowledged that the same method should have been used for the Medicare segment as was used for the total company. They specifically stated that:

Michigan's actuary agreed that the same method should have been used for the Medicare segment.

"Upon review of the method used to 'roll-up' the assets, we realized that the method did not take into account investment gains and losses."

Using Michigan's method for recognizing gains and losses for the total company plans, we calculated that the gains shown in the following table should have been, but were not, considered by Michigan in updating the assets of the Medicare segment. (See Appendix B for more details.)

Unrecognized Gains			
Year	Union	Regular	Total
1987	\$222,572	\$1,362,808	\$1,585,380
1988	78,467	355,636	434,103
1989	134,033	544,369	678,402
TOTAL	\$435,072	\$2,262,813	\$2,697,885

Participant Transfers

Michigan did not adjust for participant transfers in and out of the Medicare segment after 1986. An adjustment was required if the transfers were large enough that their nonconsideration would result in a distortion of a segment's ratio of fund assets to actuarial liabilities (CAS, section 413.50 (c)(8)).

We analyzed the effect of transfers for the years after 1986 for both the Regular and Union Plans to determine if their nonconsideration resulted in a distortion of the ratio of fund assets to actuarial liabilities for the Medicare segment. Our analysis showed that Michigan's exclusion of participant transfers significantly distorted the ratio of assets to liabilities in 1987 for the Regular Plan with regard to the Medicare segment's share of pension assets.

Exclusion of participant transfers significantly distorted the ratio of assets to liabilities in 1987.

The significance of the distortion is illustrated in the following table.

Transfer Distortion			
Description	Assets	Liabilities	Funding Level
	(A)	(B)	(A)/(B)
Considered	\$13,163,666	\$10,858,542	121.2%
Not Considered	12,232,966	10,858,542	112.7%
Difference	\$930,700	-0-	8.5%

Both the dollar amount (\$930,700) and percentage (8.5 percent) differences represent a significant distortion. Michigan should have considered transfers in 1987 concerning the Regular Plan and transferred \$930,700 in assets to the Medicare segment in 1987 in updating the Medicare segment assets from 1986 to 1990. (See Appendix A for more details.)

Computation of Medicare Assets as of 1990

We updated pension assets of the Medicare segment from July 1, 1986 to January 1, 1990. See Appendices A and B. Except for recognizing investment gains and transfers, we utilized Michigan's methodology. Our recalculation showed that the 1986 understatement of \$581,632 in pension assets of the Medicare segment increased by another \$4,440,241 (includes appreciation on the adjustments) as of January 1, 1990.

Recommendation

We recommend that Michigan:

1. Increase the January 1, 1990 pension assets of the Medicare segment by \$4,440,241.

Auditee Comments

"...we agree with the finding to increase the Medicare segment valuation by \$4,440,241 as of January 1, 1990."

INSTRUCTIONS FOR AUDITEE RESPONSE

The HHS action official will contact you to resolve the issues in this audit report. Any additional comments or information that you believe may have a bearing on the resolution of this audit may be presented at that time.

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In accordance with the principles of the Freedom of Information Act (Public Law 90-23), Office of Inspector General, Office of Audit Services reports issued to the Departments's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5.)

APPENDICES

**BLUE CROSS BLUE SHIELD OF MICHIGAN
DETROIT, MICHIGAN**

**APPENDIX A
PAGE 1 OF 4**

STATEMENT OF MEDICARE PENSION ASSETS

FOR THE PERIOD

JULY 1, 1986 TO JANUARY 1, 1990

		TOTAL COMPANY		OTHER SEGMENTS		MEDICARE SEGMENT	
		UNION	REGULAR	UNION	REGULAR	UNION	REGULAR
Assets July 1, 1986	1/	\$26,829,300	\$126,226,600	\$24,366,370	\$114,638,998	\$2,462,930	\$11,587,602
1986 Contributions	2/	6,003,900	0	5,020,611	0	983,289	0
1986 Disbursements	3/	(505,280)	(2,734,285)	(450,091)	(2,518,665)	(55,189)	(215,620)
1986 Expected Earnings	4/	2,218,396	9,364,459	1,998,873	8,503,475	219,523	860,984
1986 Transfers	5/	0	0	0	(930,700)	0	930,700
EVA July 1, 1987	6/	34,546,316	132,856,774	30,935,763	119,693,108	3,610,553	13,163,666
Recognized Gain	7/	2,129,584	13,754,426	1,907,012	12,391,618	222,572	1,362,808
Assets July 1, 1987		\$36,675,900	\$146,611,200	\$32,842,775	\$132,084,726	\$3,833,125	\$14,526,474
1987 Contributions		3,080,750	0	2,661,871	0	418,879	0
1987 Disbursements		(130,661)	(1,059,970)	106,990	(983,287)	(23,671)	(76,683)
1987 Expected Earnings		1,372,896	5,478,046	1,228,328	4,934,861	144,568	543,185
EVA January 1, 1988		40,998,885	151,029,276	36,625,984	136,036,300	4,372,901	14,992,976
Recognized Gain		735,677	3,582,442	657,210	3,226,806	78,467	355,636
Assets January 1, 1988		\$41,734,562	\$154,611,718	\$37,283,194	\$139,263,106	\$4,451,368	\$15,348,612
1988 Contributions	8/	0	0	0	0	0	0
1988 Disbursements		(1,120,980)	(5,556,686)	(1,016,669)	(5,177,577)	(104,311)	(379,109)
1988 Expected Earnings		3,101,537	11,437,805	2,771,922	10,302,060	329,615	1,135,745
EVA January 1, 1989		43,715,119	160,492,837	39,038,447	144,387,589	4,676,672	16,105,248
Recognized Gain		1,252,871	5,424,778	1,118,838	4,880,409	134,033	544,369
Assets January 1, 1989		\$44,967,990	\$165,917,615	\$40,157,285	\$149,267,998	\$4,810,705	\$16,649,617
1989 Contributions		0	0	0	0	0	0
1989 Disbursements		(2,286,808)	(10,295,725)	(2,117,046)	(9,598,470)	(169,762)	(697,255)
1989 Expected Earnings		3,498,344	12,827,261	3,120,844	11,525,506	377,500	1,301,755
EVA January 1, 1990		46,179,526	168,449,151	41,161,083	151,195,034	5,018,443	17,254,117
Recognized Gain		2,004,803	8,143,201	1,786,936	7,309,099	217,867	834,102
Assets January 1, 1990		\$48,184,329	\$176,592,352	\$42,948,019	\$158,504,133	\$5,236,310	\$18,088,219
Assets Per Michigan							
Valuation Report	9/	48,184,329	176,592,352	43,540,001	162,934,024	4,644,328	13,658,328
Asset Variance	10/	\$0	\$0	\$(591,982)	\$(4,429,891)	\$591,982	\$4,429,891

FOOTNOTES TO STATEMENT OF PENSION ASSETS

1/ Total Actuarial Value of Assets (AVA) for Union (\$26,829,300) and Regular (\$126,226,600) plans was obtained from the 1986 valuation reports of Blue Cross Blue Shield of Michigan (Michigan). We computed Medicare segment assets based on our identification of the segment and our recomputed asset fraction. The recomputed asset fraction was 9.18%. (See finding in the narrative for more details.)

2/ We obtained total contribution amounts from IRS Form 5500 reports. Contributions for the Medicare segment were recalculated in accordance with our identification of the segments. Our method of calculation, based on normal costs plus a 10-year amortization of the unfunded actuarial liability, with interest to the end of the year, was the same as Michigan's for determining the amounts to be funded. Michigan made no contributions to the trust fund for the Regular pension plan for 1986 and 1987.

3/ Total company disbursements for 1986 consisted of benefit payments and administrative expenses. We allocated administrative expenses to the Medicare segment based on the beginning of the year actuarial value of assets. Company disbursements for 1987, 1988 and 1989 consisted of only benefit payments. Michigan provided benefit payment amounts, by participant. We verified total benefit payments to IRS Form 5500 reports.

4/ Total expected earning amounts were obtained from valuation reports. Expected earnings were recalculated in accordance with our identification of the Medicare segment. Our method of calculation was the same as Michigan's. Interest rates were 7.5% for 1986 through 1988, and 8% for 1989.

5/ We identified participant transfers between segments by comparing annual participant listings provided by Michigan's actuary. The listings contained the actuarial liability of each participant at year-end. We calculated the asset transfer as follows:

		Medicare Segment	Other Segment
Actuarial Liability Transferred Out	A/	\$364,150	\$1,346,459
Funding Level	B/	<u>123.86%</u>	<u>102.62%</u>
Assets Transferred Out	C/	\$ (451,036)	\$ (1,381,736)
Assets Transferred In		<u>1,381,736</u>	<u>451,036</u>
Net Asset Transfer	D/	<u>\$930,700</u>	<u>\$(930,700)</u>

FOOTNOTES TO STATEMENT OF PENSION ASSETS

A. We determined from participant listings prepared by Michigan's actuary the amount of actuarial liability that transferred from each segment. We included the actuarial liability for each segment for employees in the segment as of the valuation date. Thus, liabilities followed the participant's movement between segments.

B. We determined the funding level at year-end, before adjusting for transfers. The funding level represented the ratio of the actuarial value of pension assets to the actuarial liabilities for each segment.

C. We determined the assets associated with the liability that transferred out by multiplying the transferee's actuarial liability by the segment's funding ratio.

D. The assets transferred out were offset against the assets transferred into the segment to determine the net change in each segment's assets.

6/ The Expected Value of Assets (EVA) represents the sum of the assets at the beginning of the year and adjustments throughout the year for contributions, disbursements, expected earnings and transfers.

7/ The Recognized Gain represents the difference between expected asset values and actual results. See Appendix B.

8/ Michigan made no contributions to the trust fund in 1988 and 1989 to either pension plan.

9/ The asset variance represents the difference between our calculation of assets as of January 1, 1990 and the assets reported in Michigan's January 1, 1990 valuation reports. Michigan prepared separate valuation reports for the total Union plan, the total Regular plan, and the Medicare segment. Assets shown for "Other Segments" was calculated by subtracting the Medicare segment assets (Union and Regular) from the total plan assets.

For years 1986 through 1989, Michigan identified the Medicare segment EVA as the AVA. They did not adjust the Medicare segment's EVA for gains, as they did for the total company (See Appendix B). In 1990, Michigan began calculating a gain for the Medicare segment in the same manner as the total company. However, they identified the gain for the Medicare segment as an "Adjustment Due to Method Change," and began amortizing it over 30 years.

FOOTNOTES TO STATEMENT OF PENSION ASSETS

The fact that Michigan began valuing Medicare segment assets in a consistent manner with the total company does not constitute a change in valuation method. Michigan should have been valuing Medicare segment assets in the same manner as the total company since July 1, 1986 and identifying appreciation of the assets as regular experience gains and losses. Also, Michigan's 1990 asset method change ignored the appreciation gains that occurred from 1986 to 1989.

10/ The asset variance represents the difference between our calculation of assets as of January 1, 1990 and the assets reported in Michigan's January 1, 1990 valuation reports. Assets shown for "Other Segments" was calculated by subtracting the Medicare segment assets (Union and Regular) from the total plan assets.

**BLUE CROSS BLUE SHIELD OF MICHIGAN
DETROIT, MICHIGAN**

**APPENDIX B
PAGE 1 OF 2**

**STATEMENT OF RECOGNIZED ASSET GAINS
FOR THE PERIOD
JULY 1, 1986 TO JANUARY 1, 1990**

		TOTAL COMPANY		OTHER SEGMENTS		MEDICARE SEGMENT	
		UNION	REGULAR	UNION	REGULAR	UNION	REGULAR
EVA July 1, 1987	1/	\$34,546,316	\$132,856,774	\$30,935,763	\$119,693,108	\$3,610,553	\$13,163,666
MVA July 1, 1987	2/	45,194,345	183,263,970	40,470,931	165,105,877	4,723,414	18,158,093
Preliminary AVA	3/	36,675,922	142,938,213	32,842,797	128,775,662	3,833,125	14,162,551
Minimum AVA	4/	36,155,476	146,611,176	32,376,745	132,084,702	3,778,731	14,526,474
Maximum AVA	5/	54,233,214	219,916,764	48,565,117	198,127,052	5,668,097	21,789,712
AVA July 1, 1987	6/	36,675,900	146,611,200	32,842,775	132,084,726	3,833,125	14,526,474
1987 Recognized Gain	7/	\$2,129,584	\$13,754,426	\$1,907,012	\$12,391,618	\$222,572	\$1,362,808
EVA January 1, 1988		\$40,998,885	\$151,029,276	\$36,625,984	\$136,036,300	\$4,372,901	\$14,992,976
MVA January 1, 1988		44,677,269	168,941,484	39,912,035	152,170,328	4,765,234	16,771,156
Preliminary AVA		41,734,562	154,611,718	37,283,194	139,263,106	4,451,368	15,348,612
Minimum AVA		35,741,815	135,153,187	31,929,628	121,736,262	3,812,187	13,416,925
Maximum AVA		53,612,723	202,729,781	47,894,442	182,604,394	5,718,281	20,125,387
AVA January 1, 1988		41,734,562	154,611,718	37,283,194	139,263,106	4,451,368	15,348,612
1988 Recognized Gain		\$735,677	\$3,582,442	\$657,210	\$3,226,806	\$78,467	\$355,636
EVA January 1, 1989		\$43,715,119	\$160,492,837	\$39,038,447	\$144,387,589	\$4,676,672	\$16,105,248
MVA January 1, 1989		49,979,474	187,616,725	44,632,637	168,789,630	5,346,837	18,827,095
Preliminary Assets		44,967,990	165,917,615	40,157,285	149,267,998	4,810,705	16,649,617
Minimum AVA		39,983,579	150,093,380	35,706,110	135,031,704	4,277,470	15,061,676
Maximum AVA		59,975,369	225,140,070	53,559,164	202,547,556	6,416,204	22,592,514
AVA January 1, 1989		44,967,990	165,917,615	40,157,285	149,267,998	4,810,705	16,649,617
1989 Recognized Gain		\$1,252,871	\$5,424,778	\$1,118,838	\$4,880,409	\$134,033	\$544,369
EVA January 1, 1990		\$46,179,526	\$168,449,151	\$41,161,083	\$151,195,034	\$5,018,443	\$17,254,117
MVA January 1, 1990		56,203,541	209,165,158	50,095,764	187,740,532	6,107,777	21,424,626
Preliminary AVA		48,184,329	176,592,352	42,948,019	158,504,133	5,236,310	18,088,219
Minimum AVA		44,962,833	167,332,126	40,076,611	150,192,426	4,886,222	17,139,701
Maximum AVA		67,444,249	250,998,190	60,114,917	225,288,638	7,329,332	25,709,551
AVA January 1, 1990		48,184,329	176,592,352	42,948,019	158,504,133	5,236,310	18,088,219
1990 Recognized Gain		\$2,004,803	\$8,143,201	\$1,786,936	\$7,309,099	\$217,867	\$834,102

FOOTNOTES TO STATEMENT OF RECOGNIZED ASSET GAINS

1/ The Expected Value of Assets (EVA) represents the sum of the prior year's actuarial value of assets, contributions, disbursements, expected earnings, and transfers for 1987. (See Appendix A.)

2/ We obtained the Market Value of Assets (MVA) for the total company from the valuation reports and verified them to IRS Forms 5500. We determined the MVA for the Medicare segment by calculating the ratio of the EVA for the Medicare segment to the total company, and applying that ratio to the total company MVA. The amounts shown for "Other Segments" MVA reflect the difference between the total company MVA and the Medicare segment MVA.

3/ We calculated the preliminary Actuarial Value of Assets (AVA) as 80% of the EVA, plus 20% of the MVA. This method of calculation was identical to the methodology used in Michigan's valuation reports for the total company.

4/ According to the CAS, the total asset value must fall within a corridor from 80% to 120% of the market value of the assets. If assets fall outside the corridor, they must be adjusted to the nearest boundary of the corridor (CAS 413.50 (b)(2)). Accordingly, we calculated the Minimum AVA as 80% of the MVA. In 1987, Michigan made a corridor adjustment to the total company Regular pension plan.

5/ We calculated the Minimum AVA as 120% of the MVA. (See footnote 4/ above.)

6/ The AVA (80% of the EVA + 20% of the MVA) can not be less than the Minimum AVA nor greater than the Maximum AVA. This method of determining the AVA is the same as Michigan's. Michigan used this method to determine the AVA for the total company Union and Regular pension plans. However, they did not use this method for the Medicare segment until 1990.

7/ We calculated the Recognized Gain as the difference between the EVA and the AVA. The gain recognized is the difference between expected and actual earnings. Michigan recognized gains for the total company, but did not recognize gains for the Medicare segment until 1990. (See finding in the Narrative for more details.)

Blue Cross
Blue Shield
of Michigan



Medicare

600 Lafayette East
Detroit, Michigan 48226
313/225-8200

April 16, 1992

Vincent R. Imbriani
Regional Inspector General
Office of Audit Services
Region VII, Room 284A
601 East 12th Street
Kansas City, MO 64106

Dear Mr. Imbriani:

Re: Audit of Medicare Segment Pension Costs
CIN: A-07-91-00471

We have reviewed the participant data that was utilized in the audit and consulted with our pension actuary, Wyatt Company, and agree with the findings of the draft audit report.

With regard to the calculation of the asset fraction, we acknowledge that 78 employees and 20 inactive participants were inadvertently omitted from the asset fraction calculation. While our actuary noted minor differences, we agree with the audit finding recommendation to increase the Medicare segment pension assets by \$581,632 to \$14,050,532 and to carry that increase forward to the January 1, 1990 segment valuation.

Wyatt Company acknowledged that the initial calculation of investment gains for the Medicare segment only included the expected interest rates and did not include an adjustment to actual rates as did the pension program as a whole.

On participant transfers in and out, Cost Accounting Standard 413 only requires this adjustment if its omission would distort the segment's ratio of fund assets to liabilities. After discussing the issue with our actuary we have decided not to challenge the adjustment and agree with the revised calculation.

As a result of increasing the asset ratio and carrying forward its effects, including an adjustment for actual investment rates, and adjusting for transfers in and out, we agree with the finding to increase the Medicare segment valuation by \$4,440,241 as of January 1, 1990.

If there are any questions, please call me on (313)
225-0703.

Sincerely,

A handwritten signature in cursive script, appearing to read "CDSchmitt", with a long horizontal flourish extending to the right.

Catherine D. Schmitt
Director
Government Budget & Planning

cc: R. Livingston
D. Palka
R. Rietz, Wyatt Co.
M. Stanton, Region V, OAS